KPMG

TOBACCO SETTLEMENT REVENUE MANAGEMENT AUTHORITY

(a Component Unit of the State of South Carolina)

Basic Financial Statements

June 30, 2002

(With Independent Auditors' Report Thereon)

State of South Carolina

Office of the State Auditor
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COLUMBIA, S.C. 29201

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STATE AUDITOR

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December 30, 2002

The Honorable Jim Hodges, Governor
and
Members of the Tobacco Settlement Revenue
Management Authority
Columbia, South Carolina

This report on the audit of the financial statements of the Tobacco Settlement Revenue Management Authority for the fiscal year ended June 30, 2002, was issued by KPMG, LLP, Certified Public Accountants, under contract with the South Carolina Office of the State Auditor.

If you have any questions regarding this report, please let us know.

Respectfully submitted,

Thomas L. Wagner, Jr., CPA
State Auditor

TLWjr/trb

TOBACCO SETTLEMENT REVENUE MANAGEMENT AUTHORITY

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303 Peachtree Street, N.E.
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Independent Auditors' Report

The Honorable Jim Hodges, Governor, and
Members of the Tobacco Settlement Revenue
Management Authority
State of South Carolina
Columbia, South Carolina:

We have audited the accompanying basic financial statements of the governmental activities and the major fund of the Tobacco Settlement Revenue Management Authority (the "Authority"), as of and for the year ended June 30, 2002, which collectively comprise the Authority's basic financial statements as listed in the table of contents. These financial statements are the responsibility of the Authority's management. Our responsibility is to express opinions on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinions.

In our opinion, the financial statements referred to above present fairly, in all material respects, the respective financial position of the governmental activities and the major fund of the Tobacco Settlement Revenue Management Authority as of June 30, 2002, and the respective changes in financial position thereof for the year then ended in conformity with accounting principles generally accepted in the United States of America.

As discussed in note 2(b) to the basic financial statements, the Authority has adopted the provisions of Governmental Accounting Standards Board Statement No. 34, *Basic Financial Statements – and Management's Discussion and Analysis – for State and Local Governments*, Statement No. 37, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments: Omnibus, an amendment of GASB Statements No. 21 and 34*, and Statement No. 38, *Certain Financial Statement Note Disclosures*, as of July 1, 2001.

In accordance with *Government Auditing Standards*, we have also issued our report dated October 11, 2002 on our consideration of the Authority's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts, and grants. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our audit.

The management's discussion and analysis on pages 3 through 7 is not a required part of the basic financial statements but is supplementary information required by accounting principles generally accepted in the United States of America. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it. The Authority has not presented the budgetary information for the General Fund that is determined by accounting principles generally accepted in the United States of America to be necessary to supplement, although not required to be part of, the basic financial statements.

KPMG LLP

October 11, 2002

TOBACCO SETTLEMENT REVENUE MANAGEMENT AUTHORITY

Management's Discussion and Analysis

June 30, 2002

This Section of the annual financial report of the Tobacco Settlement Revenue Management Authority (the "Authority") presents the analysis of the Authority's financial performance during the fiscal year that ended on June 30, 2002. Please read it in conjunction with the financial statements and their accompanying notes, which follow this section.

The Authority

The Authority was created by Act No. 387 of the Acts and Joint Resolutions of the General Assembly of the State of South Carolina, Regular Session of 2000, as codified at S.C. Code Ann. §§ 11-49-10 *et seq*. (the "Act"), as an instrumentality of the State of South Carolina (the "State"). The Act created the Authority to receive all of the State's payments under the Master Settlement Agreement (the "MSA"). The MSA was entered into on November 23, 1998, among the attorneys general of 46 states (including South Carolina), the District of Columbia, the Commonwealth of Puerto Rico, Guam, the U.S. Virgin Islands, American Samoa and the Commonwealth of the Northern Mariana Islands (collectively the "Settling States") and the four largest United States tobacco manufacturers: Philip Morris Incorporated, R. J. Reynolds Tobacco Company, Brown & Williamson Tobacco Corporation, and Lorillard Tobacco Company (collectively the "Original Participating Manufacturers" or "OPMs"). The MSA resolved cigarette smoking-related litigation among the Settling States and the OPMs, released the OPMs from past and present smoking-related claims by the Settling States, and provides for a continuing release of future smoking-related claims in exchange for certain payments to be made to the Settling States. The MSA also provides for the imposition of certain tobacco advertising and marketing restrictions, among other things. The Authority is not a party to the MSA.

The State is entitled to certain periodic payments made under the MSA. Pursuant to the Act, the Authority has been assigned all Tobacco Settlement Receipts ("TSRs"), which are the State's right, title and interest in payments due after June 30, 2001 under the MSA. On March 18, 2001, the Authority issued $934,530,000 aggregate principal amount of Tobacco Settlement Asset-Backed Bonds (the "Bonds") pursuant to an indenture between the Authority and United States Trust Company of New York (subsequently acquired by The Bank of New York), as trustee, dated as of March 1, 2001, and the Tobacco Settlement Revenue Management Authority Act. The Bonds are secured by and payable from i) the TSRs and all investment earnings on amounts on deposit in certain accounts established under the indenture and ii) all amounts, if any, on deposit in certain accounts under the indenture. Payments on the Bonds are a special obligation of the Authority, and such payments are dependent on receipt by the Trustee, as assignee of the Authority, of TSRs. The Authority has no financial assets other than the TSRs, the accounts established under the indenture, and investment earnings on those accounts. The Bonds are not a debt of the State, and the Authority does not have the power to pledge the credit, revenues or taxing power of the State. The Authority does not have taxing power.

As of June 30, 2002, there remained outstanding $902.92 million of the debt originally issued by the Authority. A discussion concerning the status of the bonds follows in the section entitled "Summary and Comparison of Financial Results".

Overview of the Financial Statements

This discussion and analysis is intended to serve as an introduction to the Authority's basic financial statements. The Authority's basic financial statements consist of three components: 1) government-wide financial statements, 2) governmental fund financial statements, and 3) notes to the financial statements. Due to the single purpose nature of the activities of the Authority, the government-wide and governmental fund financial statements have been presented together with an adjustments column reconciling the differences.

- The *Statement of Net Assets and Governmental Fund Balance Sheet* includes all of the Authority's assets and liabilities and provides information about the nature and amounts of investments in resources (assets) and the obligations to Authority creditors (liabilities). It also provides the basis for computing rate of return, evaluating the capital structure of the Authority and assessing the liquidity and financial flexibility of the Authority. The Statement of Net Assets column reports information about the Authority using accounting methods similar to those used by private sector companies and presents all assets and liabilities of the Authority – both current and long-term. The Governmental Fund Balance Sheet of the General Fund focuses only on the Authority's balances of spendable resources available at the end of the fiscal year.
- All of the current year's activity is accounted for in the *Statement of Activities and Governmental Fund – Revenues, Expenses and Changes in Fund Balance*. These statements measure the success of the Authority's operations over the past year and can be used to determine the Authority's ability to meet its financial objectives and credit-worthiness. The Statement of Activities column presents information on how the Authority's net assets changed during the most recent fiscal year. All changes in net assets are reported as soon as the underlying event giving rise to the change occurs, regardless of the timing of related cash flows. The Governmental Fund Balance Sheet for the General Fund focuses only on the Authority's near-term inflows and outflows of spendable resources for the fiscal year.

Summary of Financial Results

Government-Wide Financial Statements

Statement of Net Assets. Table 1 summarizes the Authority's Statement of Net Assets for the period ending June 30, 2002. In future years, when prior period information is available, a comparative analysis of the Authority's activity will be presented.

Table 1: Summary of Net Assets

	June 30, 2002
Cash and Cash Equivalents	$ 126,281
Restricted Assets	117,937,367
Total Assets	$ 118,063,648
Accrued Interest Payable	$ 7,361,002
Long-Term Liabilities	902,920,000
Total Liabilities	$ 910,281,002
Total Net Assets (Deficit)	$(792,217,354)

The Authority's assets include cash and cash equivalents, investments, and earnings on those investments. Approximately 99% of the Authority's assets are comprised of investments held in various reserve funds by the bond trustee, as security for the bondholders. The remaining assets are held by the Authority to pay its authorized operating expenses.

Total liabilities consist of the principal balance of the Bonds outstanding in the amount of $902,920,000 and accrued interest payable on those bonds as of the end of the fiscal year.

The significant deficit reflected on the Authority's Statement of Net Assets is a result of the Authority having no financial assets other than the TSRs, the accounts established under the indenture, and investment earnings on those accounts. Future TSRs are dependent on many factors including future tobacco consumption and the financial capability of the OPMs and as a result, TSRs do not meet asset recognition criteria under accounting principles generally accepted in the United States of America ("GAAP"). Accordingly, the financial statements reflect a deficit arising as a consequence of the full recognition of Authority liabilities, comprised primarily of the outstanding Bonds, without attendant currently recognizable Authority assets.

Statement of Activities. Table 2 summarizes the Authority's Statement of Activities for the period ending June 30, 2002.

Table 2: Summary of Activities

	June 30, 2002
General Revenues	$ 93,522,216
Expenses	61,091,240
Change in Net Assets	$ 32,430,976
Net Assets (Deficit) – Beginning of Year	$ (824,648,330)
Net Assets (Deficit) – End of Year	$ (792,217,354)

General Revenues of $93.5 million reflect the receipt of $86.1 million in TSRs, along with investment earnings of $7.4 million. The Authority's expenses primarily included interest on the Bonds totaling $61.0 million.

Governmental Fund Financial Statements

Governmental Fund Balance Sheet. Table 3 summarizes the Authority's Balance Sheet for its General Fund for the period ending June 30, 2002.

Table 3: Summary Governmental Fund Assets and Liabilities

	June 30, 2002
Cash and Cash Equivalents	$ 126,281
Restricted Assets	117,937,367
Total Assets	$ 118,063,648
Total Liabilities	--
Total Fund Balance	$ 118,063,648

The Authority's assets as reported on the Governmental Fund Balance Sheet are the same as the assets presented on the Statement of Net Assets. There are no liabilities on the Governmental Fund Balance Sheet because all of the Authority's liabilities are long-term in nature or relate to liabilities reported on a cash basis.

Governmental Fund Statement of Revenue, Expenditures, and Changes in Fund Balance. Table 4 summarizes the Authority's Governmental Fund Revenues, Expenditures and Changes in Fund Balance for the period ending June 30, 2002.

Table 4: Summary Governmental Fund Revenues, Expenses and Changes in Fund Balance

	June 30, 2002
General Revenues	$ 93,522,216
Expenditures	102,030,519
Change in Net Assets	$ (8,508,303)
Fund Balance – Beginning of Year	$ 126,571,951
Fund Balance – End of Year	$ 118,063,648

General Revenues of $93.5 million reflect the receipt of $86.1 million in TSRs, along with investment earnings of $7.4 million. The Authority's expenditures primarily included interest due on the Bonds totaling $70.3 million and early extinguishment of debt of $31.6 million.

Long Term Debt Activity

The Bonds issued by the Authority are thirty-year obligations scheduled to retire in ordinary course on May 15, 2030. However, under early redemption provisions, particularly Turbo Redemptions, any MSA payments exceeding annual debt service requirements of the Bonds must be applied to early redemption of principal. TSRs and earnings on the trust funds during the Fiscal Year ended June 30, 2002 resulted in the Turbo Redemption of $31.61 million in outstanding debt.

Because the Authority has pledged all future TSRs to the Bonds currently outstanding until those Bonds have been retired, the Authority cannot issue additional debt without effecting a refunding of currently outstanding Bonds. Presently, the Authority has no plans to undertake any transaction that would result in an increase in currently outstanding debt. The Authority monitors market conditions for circumstances conducive to undertaking a refunding transaction that would result in savings of interest expense over time. No such conditions arose during the most recently completed fiscal year.

Economic Factors and Outlook

In structuring the financial transaction for issuance of the Bonds, the Authority engaged the services of an independent consultant to develop a forecast of future tobacco rates of consumption and likely TSRs based on those forecasted rates of consumption. All future payments on the Bonds, including timely debt service, sinking fund redemption payments, and Turbo Redemptions are contingent on future TSRs, and those TSRs are dependent on rates of consumption of tobacco products.

Contacting the Authority

Persons needing additional information concerning this report or otherwise needing to contact the Authority may do so by writing or telephoning F. Richard Harmon, Jr., Senior Assistant State Treasurer, State of South Carolina, 122 Wade Hampton Office Building, Capitol Complex, Columbia, South Carolina 29201; telephone (803) 734-2114; facsimile (803) 734-2039; e-mail harmr@sto.state.sc.us.

TOBACCO SETTLEMENT REVENUE MANAGEMENT AUTHORITY

Statement of Net Assets and Governmental Fund Balance Sheet

June 30, 2002

	General Fund	Adjustments (Note 3)	Statement of Net Assets
Assets			
Cash and cash equivalents	$ 126,281	$ -	$ 126,281
Restricted assets:			
Cash and cash equivalents	148,712	-	148,712
Investments	115,291,236	-	115,291,236
Accrued interest receivable	2,497,419	-	2,497,419
Total assets	$ 118,063,648	-	118,063,648
Liabilities			
Liabilities payable from restricted assets:			
Accrued interest payable	$ -	7,361,002	7,361,002
Long-term debt:			
Due after one year	-	902,920,000	902,920,000
Total liabilities	-	910,281,002	910,281,002
Fund Balance/Net Assets (Deficit)			
Fund balance:			
Reserved for debt service	117,937,367	(117,937,367)	-
Unreserved	126,281	(126,281)	-
Total fund balance	118,063,648	(118,063,648)	-
Total liabilities and fund balance	$ 118,063,648		
Net assets (deficit):			
Unrestricted		(792,217,354)	(792,217,354)
Total net assets (deficit)		$ (792,217,354)	$ (792,217,354)

See accompanying notes to basic financial statements.

TOBACCO SETTLEMENT REVENUE MANAGEMENT AUTHORITY

Statement of Activities and Governmental Fund
Revenues, Expenditures, and Changes in Fund Balance
For the Year Ended June 30, 2002

	General Fund	Adjustments (Note 3)	Statement of Activities
Expenditures/expenses			
General government	$ 82,905	$ -	$ 82,905
Debt service:			
Principal	31,610,000	(31,610,000)	-
Interest	70,337,614	(9,329,279)	61,008,335
Total expenditures/expenses	102,030,519	(40,939,279)	61,091,240
Net program expense			61,091,240
General revenues			
Tobacco settlement revenues	86,078,586	-	86,078,586
Investment earnings	7,443,630	-	7,443,630
Total general revenues	93,522,216	-	93,522,216
Excess (deficiency) of revenues over (under) expenditures	(8,508,303)	8,508,303	-
Change in net assets	-	(32,430,976)	32,430,976
Fund balance/net assets (deficit)			
Beginning of the year	126,571,951	(951,220,281)	(824,648,330)
End of the year	$ 118,063,648	$ (975,142,954)	$ (792,217,354)

See accompanying notes to basic financial statements.

(1) Reporting Entity

The Tobacco Settlement Revenue Management Authority (the Authority) is a public body and an instrumentality of the State of South Carolina (the State) established in 2001 pursuant to Section 11-49-30 of the South Carolina Code of Laws as amended. The State transferred to the Authority all of its rights and interests under the Master Settlement Agreement (the MSA) and the Consent Decree and Final Judgment (the Decree) between all participating States and the participating Tobacco manufacturers. These rights include the State's share of all Tobacco Settlement revenue received after June 30, 2001 and in perpetuity to be received under the MSA. See further explanation in notes 5 and 6.

The core of a financial reporting entity is the primary government which has a separately elected governing body. As required by accounting principles generally accepted in the United States of America, the financial reporting entity includes both the primary government and all of its component units. Component units are legally separate organizations for which the elected officials of the primary government are financially accountable. In turn, component units may have component units.

An organization other than a primary government may serve as a nucleus for a reporting entity when it issues separate financial statements. That organization is identified herein as a primary entity. The Authority has determined it has no component units and that the Authority qualifies as a primary entity.

In accordance with Governmental Accounting Standards Board (GASB) Statement No. 14, *The Financial Reporting Entity*, a primary government or entity is financially accountable if its officials or appointees appoint a voting majority of an organization's governing body including situations in which the voting majority consists of the primary entity's officials serving as required by law (e.g., employees who serve in an ex officio capacity on the component unit's board are considered appointments by the primary entity) and (1) it is able to impose its will on that organization or (2) there is a potential for the organization to provide specific financial benefits to, or impose specific financial burdens on, the primary entity. The primary entity also may be financially accountable if an organization is fiscally dependent on it even if it does not appoint a voting majority of the board. An organization is fiscally independent if it holds all of the following powers:

(1) Determines its budget without another government having the authority to approve and modify that budget.

(2) Levies taxes or sets rates or charges without approval by another government.

(3) Issues bonded debt without approval by another government.

The organization is fiscally dependent on the primary government or entity that holds one or more of the above powers. Based on these criteria, the Authority is a blended component unit of the primary government of the State. Accordingly, the financial statements are blended in the State's special revenue funds in its Comprehensive Annual Financial Report.

The Authority is governed by a board, which consists of five members. The members are the Governor or his designee, the State Treasurer, the Comptroller General, the Chairman of the Senate Finance Committee, and the Chairman of the House Ways and Means Committee. The Governor serves as chairman; in the

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absence of the Governor, the meeting must be chaired by the State Treasurer. All members of the Board serve ex officio.

(2) Summary of Significant Accounting Policies

(a) General

In its accounting and financial reporting in conformity with accounting principles generally accepted in the United States of America, the Authority follows the pronouncements of the GASB.

(b) Government-wide and Fund Financial Statements/New Accounting Standard Adopted

In fiscal year 2002, the Authority adopted three new statements of financial accounting standards issued by the GASB:

- Statement No 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*
- Statement No. 37, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments: Omni bus, an amendment of GASB Statements No. 21 and 34*
- Statement No. 38, *Certain Financial Statement Note Disclosures*

Statement No. 34 (as amended by Statement No. 37) represents a very significant change in the financial reporting model used by state and local governments.

Statement No. 34 requires government-wide financial statements to be prepared using the accrual basis of accounting and the economic resources measurement focus. Government-wide financial statements (i.e. the statement of net assets and the statement of activities) do not provide information by fund or account group. Significantly, the statement of net assets will include noncurrent liabilities which were previously recorded in the General Long-term Debt Account Group.

The statement of activities demonstrates the degree to which direct expenses of a given function or segment are offset by program revenues. Direct expenses are those that are clearly identifiable with a specific function or segment. Program revenues include 1) charges to customers who purchase, use, or benefit from the services provided by a given function or segment and 2) grants and contributions that are restricted to meeting the operational or capital requirements of a particular function or segment. Unrestricted interest income and other items not properly included among program revenues are reported as general revenues. The Authority has no program revenues.

In addition to the government-wide financial statements, the Authority has prepared financial statements for the Authority's only governmental fund. Governmental fund financial statements continue to use the modified accrual basis of accounting and the current financial resources measurement focus. Accordingly, the accounting and financial reporting of the fund financial statements is similar to that previously presented in the Authority's financial statements, although the format of the financial statements has been modified by Statement No. 34. Due to the single purpose

(Continued)

nature of the activities of the Authority, the government-wide and fund financial statements have been presented together with an adjustments column reconciling the differences.

Statement No. 34 was implemented by the Authority effective July 1, 2001. The government-wide financial statements present Net Assets at the beginning of the year which were accumulated as follows:

Assets	$ 126,571,951
Less: Long term liabilities	(934,530,000)
Accrued interest payable	(16,690,281)
Net Assets (Deficit), Beginning of Year	$ (824,648,330)

Statement No. 34 also requires as required supplementary information Management's Discussion and Analysis which includes an analytical overview of the Authority's financial activities.

Statement No. 38 requires certain disclosures to be made in the notes to the financial statements concurrent with the implementation of Statement No. 34. While the Statement did not affect amounts reported in the financial statements of the Authority, certain note disclosures have been added and or amended including future debt service obligations in five year increments.

(c) Measurement Focus, Basis of Accounting, and Financial Statement Presentation

The government-wide financial statements are reported using the economic resources measurement focus and the accrual basis of accounting. Revenues are recorded when earned and expenses are recorded when a liability is incurred, regardless of the timing of related cash flows.

Governmental fund financial statements are reported using the current financial resources measurement focus and the modified accrual basis of accounting. Revenues are recognized as soon as they are considered measurable and available. Revenues are considered available when they are collectible within the current period or soon enough thereafter to pay liabilities of the current period. For this purpose, the Authority considers revenues to be available if they are collected within one year after the end of the current fiscal period. This is a change from the prior year when the Authority considered revenue to be available if they were collected within 60 days after the end of the year, however this change in policy had no effect on beginning of the year fund balance in the governmental fund. Expenditures generally are recorded when a liability is incurred.

The future collection of Tobacco Settlement Revenue (TSRs) is dependent on many factors, including future cigarette consumption. As such the future collection is not measurable and is not recorded as an asset in either the government-wide financial statements or the governmental fund financial statements.

The Authority reports one governmental fund – the General Fund – which is the general operating fund of the Authority. It is used to account for all financial resources of the Authority. As a blended component unit of the State, the Authority's General Fund is reported as a special revenue fund in the financial statements of the State.

When both restricted and unrestricted resources are available for use, it is the Authority's policy to use restricted resources first, then unrestricted resources as they are needed.

(d) Cash and Cash Equivalents

Cash includes cash on hand, demand deposits, and short-term investments with original maturities of three months or less from the date acquired by the Authority.

(e) Investments

Investments are recorded on the statement of net assets and the balance sheet at fair value. All investment income, including changes in the fair value of investments, is reported as revenue in the statement of activities and the statement of revenues, expenditures, and changes in fund balance.

(f) Restricted Assets

The bond indenture states that the trustee shall establish and maintain the following segregated trust accounts in the issuer's name: (1) the Collections Account; (2) the Debt Service Account; (3) the Partial Lump Sum Payment Account; (4) the Liquidity Reserve Account; and (5) the Turbo Redemption Account.

The Liquidity Reserve Account has a balance at June 30, 2002 of $85,805,738. The Authority is required to maintain a balance equal to the maximum annual debt service on the Series 2001 Term Bonds as of their date of issuance, based on the assumption that all sinking fund installments are paid when due, in the Liquidity Reserve Account, to the extent of available funds.

Amounts on deposit in the Liquidity Reserve Account will be available to pay term bond maturities and sinking fund installments of, and interest on, the Series 2001 Term Bonds to the extent collections are insufficient for such purpose. Any amount remaining after such payments in excess of the Liquidity Reserve Requirement will be deposited in the "Collection Account." Unless an event of default has occurred, amounts withdrawn from the Liquidity Reserve Account will be replenished from collections.

Within the Debt Service Account, there is an Interest Reserve Subaccount. The balance of the Interest Reserve Subaccount at June 30, 2002 is $29,553,000. The balance in the Collections Account, the Partial Lump Sum Payment Account, and the Turbo Redemption Account at June 30, 2002 is $36,167.

(g) Fund Equity

In the governmental fund financial statements, reservations of fund balance are reported for amounts that are legally restricted by the bond indenture for debt service. Restricted net assets are reported in the statement of net assets for amounts that are legally restricted by the bond indenture for debt service. The State should report the Authority's unrestricted net assets as restricted as the amounts are legally restricted by the bond indenture to be spent on the general operations of the Authority and are not unrestricted for the State as a whole.

(h) Administrative Expenses

The State of South Carolina performs certain accounting, legal, and administrative services for the Authority for which it receives no compensation. The value of such service was deemed immaterial to the Authority's financial statements.

(i) Budgetary Information

Section 11-49-60 of the Code of Laws requires the Authority to adopt an annual budget. Annual budgets are to be adopted on a basis consistent with accounting principles generally accepted in the United States of America for all governmental funds. The Authority's management prepared an informal budget during this period; however, this budget was not formally adopted by the governing board. Accordingly, the Authority elected not to present a schedule of revenue, expenditures, and changes in fund balance – budget and actual for the general fund for the year ended June 30, 2002. The presentation of such a statement for those governmental funds for which budgets have been legally adopted is required by accounting principles generally accepted in the United States of America. The Authority has officially adopted a budget for fiscal year 2003 based on the sinking fund year ending March 31, 2003.

(j) Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. Actual results could differ from those estimates.

(3) Reconciliation of government-wide and fund financial statements

(a) Explanation of adjustments between the governmental fund balance sheet and the government-wide statement of net assets

The Governmental fund balance sheet is adjusted for the following items to report the statement of net assets.

Interest on long-term debt is not accrued in governmental funds, but rather is recognized as an expenditure when due.	7,361,002
Long-term liabilities applicable to the Authority's governmental activities are not due and payable in the current period and accordingly are not reported as fund liabilities. All liabilities – both current and long-term – are reported in the statement of net assets.	902,920,000

(b) Explanation of adjustments between the governmental fund statement of revenues, expenditures, and changes in fund balance and the government-wide statement of activities

The Governmental fund statement of revenues, expenditures, and changes in fund balance is adjusted for the following items to report the statement of activities.

Repayment of bond principal is reported as an expenditure in governmental funds and, thus, has the effect of reducing fund balance because current financial resources have been used. For the Authority as a whole, however, the principal payments reduce the liabilities in the statement of net assets and do not result in an expense in the statement of activities.	31,610,000
Interest expense in the statement of activities differs from the amount reported in the governmental funds due to the change in accrued interest between fiscal year ends being calculated for bonds payable being recorded in the statement of activities.	9,329,279

(4) Deposits and Investments

At June 30, 2002, the Authority's deposits and investments consisted of the following:

Description	Maturity date		Fair value and reported value June 30, 2002
Cash and cash equivalents – cash on deposit (bank balance and carrying value)		$	274,993
Investments:			
Federal National Mortgage Association	August 7, 2002	$	85,805,738
Federal Home Loan Bank	November 14, 2002		29,485,498
Total		$	115,291,236

Deposits – Most deposits are under the control of the State Treasurer who, by law, has sole authority for investing State funds. State law requires full collateralization of all State Treasurer bank balances. The State Treasurer must correct any deficiencies in collateral within two days. At June 30, 2002, all State Treasurer bank balances were fully insured or collateralized with securities held by the State.

Investments – The Authority's investment policy provides for eligible investments in obligations of FHLMC, FNMA, or Federal Farm Credit System, demand and time deposit accounts and certificates of deposit, general obligations of states and guaranteed state obligations, commercial or finance company paper, repurchase obligations, corporate securities bearing interest or sold at discount, taxable money market funds, investment agreements or guaranteed investment contracts, and other obligations or securities that are investment agreements or guaranteed investment contracts and other obligations or securities that are noncancelable.

The Authority's investments are held by the trustee in several restricted accounts in the name of the Authority. The Authority's investments are categorized to give an indication of the level of risk assumed by the entity at year-end. The credit risk categories are concerned with custodial credit risk, which is the risk that a government will not be able to recover the value of investment or collateral securities that are in the possession of an outside party if the counterparty to the investment transaction fails. There are three categories of credit risk. Category 1 includes investments that are insured or registered or for which the securities are held by the entity or its agent in the Authority's name. Category 2 includes uninsured and unregistered investments for which the securities are held by the counterparty's trust department or agent in the Authority's name. Category 3 includes uninsured and unregistered investments for which the securities are held by the counterparty or by its trust department or agent but not in the Authority's name. The Authority's investments at June 30, 2002 are considered category 2.

(5) Bonds Payable

On March 22, 2001, the Authority issued asset-backed bonds pursuant to an indenture between the Authority and United States Trust Company of New York, as trustee, dated as of March 1, 2001 (the Indenture). The State transferred to the Authority all of its rights and interests under the Master Settlement Agreement (the MSA) and the Consent Decree and Final Judgment (the Decree). These rights include the State's share of all Tobacco Settlement revenue received after June 30, 2001 and in perpetuity to be received under the MSA. The consideration paid by the Authority to the State for such rights consisted of $785,750,514 cash. Also, the State (primary government) transferred $75,000 to the Authority to finance initial activities prior to the issuance of the bonds.

The MSA is an industry-wide settlement of litigation between the Settling States and the Original Participating Manufacturers (OPMs) and was entered into between the attorneys general of the Settling States and the OPMs on November 23, 1998. The MSA provides for other tobacco companies, referred to as Subsequent Participating Manufacturers (the SPMs), to become parties to the MSA. The four OPMs together with the 25 SPMs are referred to as the Participating Manufacturers (PMs). The settlement represents the resolution of a large potential financial liability of the PMs for smoking-related injuries, the costs of which have been borne and will likely continue to be borne by cigarette consumers. Pursuant to the MSA, the Settling States agreed to settle all their past, present, and future smoking-related claims against the PMs in exchange for agreements and undertakings by the PMs concerning a number of issues. These issues include, among others, making payments to the Settling States, abiding by more stringent advertising restrictions, and funding educational programs, all in accordance with the terms and conditions set forth in the MSA. Distributors of PMs products are also covered by the settlement of such claims to the same extent as the PMs.

In 2001, the Authority issued $934,530,000 of Tobacco Settlement Asset-Backed Bonds consisting of $200,000,000 Series 2001A (Taxable) Term Bonds and $734,530,000 Series 2001B (Tax-Exempt) Term Bonds (collectively, the Series 2001 Term Bonds). The Series 2001 Term Bonds were issued by the Authority pursuant to an Indenture between the Authority and United States Trust Company of New York, as trustee, dated as of March 1, 2001.

Long-term debt at June 30, 2002 is composed of the following:

2001 Series A (Taxable) Term Bonds due May 15, 2016 with interest of 7.666% due semiannually on May 15th and November 15th, commencing on November 15, 2001	$	168,390,000
2001 Series B (Tax-Exempt) Term Bonds due May 15, 2022 with interest of 6% due semiannually on May 15th and November 15th, commencing November 15, 2001		225,880,000
2001 Series B (Tax-Exempt) Term Bonds due May 15, 2028 with interest of 6.375% due semiannually on May 15th and November 15th, commencing November 15, 2001		347,265,000
2001 Series B (Tax-Exempt) Term Bonds due May 15, 2030 with interest of 6.375% due semiannually on May 15th and November 15th, commencing November 15, 2001		161,385,000
	$	902,920,000

The "sinking fund installment" of the Series 2001 Term Bonds represents the amount of principal that the Authority will pay as of the specified distribution date (each a sinking fund payment date) from collections of TSRs and, if necessary, the Liquidity Reserve Account.

A failure by the Authority to pay the sinking fund installment of the Series 2001 Bonds, on the applicable sinking fund installment payment date, will not constitute an event of default under the Indenture. However, a failure to pay interest on the Series 2001 Term Bonds when due or principal of the Series 2001 Term Bonds by their maturity dates will constitute an event of default under the Indenture.

"Turbo Redemptions" represent the requirement contained in the Indenture to apply 100% of all collections that are in excess of the requirements in the Indenture for the funding of the operating expenses, the deposits to the "Debt Service Account" for the funding of interest, sinking fund installments, and term bond maturities, maintenance of the Liquidity Reserve Account and the "Operating Contingency Account" (such excess, surplus collections), to the redemption of Series 2001 Term Bonds on each distribution date (each a Turbo Redemption Date) in ascending order of maturity. Such surplus collections will be deposited in an account established and maintained by the trustee under the Indenture (the Turbo Redemption Account). Turbo Redemptions will be credited against sinking fund installments for any particular Series 2001 Term Bonds in ascending order of sinking fund installment dates. Turbo Redemptions are not scheduled amortization payments and are to be made only from surplus collections, if any, and from amounts on deposit in the "Partial Lump-Sum Payment Account" with confirmation from each rating agency that no rating then in effect, with respect to the Series 2001 Term Bonds, from such rating agency will be withdrawn, reduced, or suspended. Amounts in the Liquidity Reserve Account will not be available to make Turbo Redemptions. As no scheduled principal payments were originally scheduled until 2003, all payments made in 2002, which totaled $31,610,000, were Turbo Redemptions.

The Authority debt service requirements based upon required sinking fund and interest payments, as adjusted for the Turbo Redemptions made as of June 30, 2002, are as follows:

	Sinking fund payments	Interest	Total debt service
Twelve months ended June 30:			
2003	$ —	58,888,015	58,888,015
2004	—	58,888,015	58,888,015
2005	—	58,888,015	58,888,015
2006	—	58,888,015	58,888,015
2007	—	58,888,015	58,888,015
2008 – 2012	107,115,000	279,692,607	386,807,607
2013 – 2017	91,700,000	241,129,561	332,829,561
2018 – 2022	195,455,000	199,531,988	394,986,988
2023 – 2027	279,050,000	128,854,369	407,904,369
2028 – 2030	229,600,000	30,233,119	259,833,119
	$ 902,920,000	1,173,881,719	2,076,801,719

The Authority's long-term liability activity for the year ended June 30, 2002, was as follows:

Bonds	Balance June 30, 2001	Additions	Reductions	Balance June 30, 2002
Series 2001 Bonds	$ 934,530,000	-	31,610,000	902,920,000

(6) Concentration of Credit Risk

The payment of the Series 2001 Term Bonds is dependent on the receipt of TSRs. The amount of TSRs actually collected is dependent on many factors, including cigarette consumption and the continued financial capability of the OPMs. Such bonds are secured by and payable solely from TSRs and investment earnings pledged under the Bond Indenture and amounts established and held in accordance with the Bond Indenture.

The Series 2001 Term Bonds are payable only from the assets of the Authority. In the event that the assets of the Authority have been exhausted, no amounts will thereafter be paid on the Series 2001 Term Bonds. The Series 2001 Term Bonds are not legal or moral obligations of the State, and no recourse may be had thereto for payment of amounts owing on the Series 2001 Term Bonds. The Authority's only source of funds for payments on the Series 2001 Term Bonds are the TSRs. The Authority has no taxing power.

(7) Contingencies

Certain smokers, consumer groups, cigarette manufacturers, cigarette importers, cigarette distributors, native American tribes, taxpayers, taxpayers' groups, and other parties have instituted litigation against various tobacco manufacturers, including the PMs, as well as certain of the Settling States and other public entities. The lawsuits allege, among other things, that the MSA violates certain provisions of the United States Constitution, state constitutions, the Federal antitrust laws, Federal civil rights laws, state consumer protection laws, and unfair competition laws, certain of which actions, if ultimately successful, could result in a determination that the MSA is void or unenforceable. The lawsuits seek, among other things, an injunction against one or more of the Settling States from collecting any monies under the MSA and barring the PMs from collecting cigarette price increases related to the MSA and/or a determination that the MSA is void or unenforceable. In addition, class action lawsuits have been filed in several Federal and state courts alleging that under the Federal Medicaid law, any amount of tobacco settlement funds that the Settling States receive in excess of what they paid through the Medicaid program to treat tobacco-related diseases should be paid directly to Medicaid recipients. To date, no such lawsuits have been successful. The enforcement of the terms of the MSA may, however, continue to be challenged in the future. In the event of an adverse court ruling, the Authority may not have adequate financial resources to make payment on the Series 2001 Term Bonds.

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Independent Auditors' Report on Compliance and on Internal Control Over Financial Reporting Based on an Audit of Financial Statements Performed in Accordance With *Government Auditing Standards*

The Honorable Jim Hodges, Governor, and
Members of the Tobacco Settlement Revenue
Management Authority
State of South Carolina
Columbia, South Carolina:

We have audited the basic financial statements of the Tobacco Settlement Revenue Management Authority (the "Authority"), a component unit of the State of South Carolina, as of and for the year ended June 30, 2002, and have issued our report thereon dated October 11, 2002. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards,* issued by the Comptroller General of the United States.

Compliance

As part of obtaining reasonable assurance about whether the Authority's basic financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grants, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit and, accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance that are required to be reported under *Government Auditing Standards.*

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the Authority's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the basic financial statements and not to provide assurance on the internal control over financial reporting. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be material weaknesses. A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control over financial reporting and its operation that we consider to be material weaknesses.

This report is intended solely for the information and use of the Members of the Authority, management, and federal awarding agencies and is not intended to be and should not be used by anyone other than these specified parties.

KPMG LLP

October 11, 2002